

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
VON FORD ASSOCIATES	:	DETERMINATION
for Revision of a Determination or for Refund	:	DTA NO. 810849
of Tax on Gains Derived from Certain Real	:	
Property Transfers under Article 31-B of the	:	
Tax Law.	:	

Petitioner, Von Ford Associates, 4 New King Street, Purchase, New York 10577, filed a petition for revision of a determination or for refund of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law.

On December 21, 1992 and January 5, 1993, respectively, petitioner by Lewis Montana, Esq., and the Division of Taxation by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel) consented to have the controversy determined on submission without a hearing, with all documentary evidence and briefs due by April 9, 1993. The Division of Taxation submitted documentary evidence on January 27, 1993. Petitioner submitted evidence and a brief on February 8, 1993. The Division of Taxation submitted its brief on March 23, 1993 and petitioner submitted its reply brief on April 6, 1993. After due consideration of the record, Marilyn Mann Faulkner, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the Division of Taxation properly calculated, for purposes of real property transfer gains tax, petitioner's consideration for the transfer of an option to purchase real property by totalling the present value of the net rental payments under a 21-year lease plus the consideration paid for the option which is exercisable in the 18th year of the lease.

II. Whether the original purchase price should be calculated under Tax Law § 1440.5(a) or (d).

FINDINGS OF FACT

On December 7, 1992 and December 10, 1992, respectively, the Division of Taxation ("Division") and petitioner, Von Ford Associates, signed a stipulation of facts which has been incorporated in the following Findings of Fact.

On or about December 5, 1989, petitioner entered into a ground lease with Kaiser Foundation Health Plan of New York (the "transferee"). The ground lease has been amended seven times as follows:

- Amendment to Ground Lease, dated July 16, 1990
- Second Amendment to Ground Lease, dated August 29, 1990
- Third Amendment to Ground Lease, dated November 9, 1990
- Fourth Amendment to Ground Lease, dated January 2, 1991
- Fifth Amendment to Ground Lease, dated January 16, 1991
- Sixth Amendment to Ground Lease, dated January 24, 1991
- Seventh Amendment to Ground Lease, dated March 13, 1992

(Hereinafter collectively referred together with the ground lease as the "Ground Lease".)

The maximum term of the Ground Lease is 21 years; the term of the lease commenced on January 29, 1991.

The Ground Lease contains an option to purchase fee title¹

which may be exercised by the transferee any time after the 18th anniversary of the lease commencement date of January 29, 1991 up to the remaining 21-year term of the lease.

On or about November 21, 1990, petitioner submitted the TP-580 and TP-581, Real Property Transfer Gains Tax Questionnaire, and related materials. The Division received such materials on or about November 23, 1990.

On December 7, 1990, Form TP-582, Gains Tax Tentative Assessment and Return No. A26897-2, was issued, which indicated a gross consideration of \$3,649,059.36, from which a brokerage fee (\$550,000.00) and original purchase price (\$700,000.00) were deducted to arrive at a gain of \$2,399,059.36, and a tax due of \$239,905.94.

Thereafter, petitioner submitted a Supplemental Return whereby payment of the gains

¹The Ground Lease does not provide for a separate payment for the option to purchase in year 18.

tax on an installment basis was elected; the annual installment as computed by petitioner was \$15,993.73.

Petitioner paid the first installment of \$15,993.75 on or about January 29, 1991.

Petitioner paid the second installment of \$15,993.75, plus interest of \$23,986.26, amounting in all to \$39,979.99, on or about January 21, 1992.

On February 6, 1991, petitioner submitted Form TP-165.8, Claim for Refund of Real Property Transfer Gains Tax, concerning the first installment payment of \$15,993.75. Petitioner noted that the Division calculated the consideration based on the entire 21 years of rent payments. Petitioner claimed that no tax is owing because the transferee may default under the Ground Lease or may not exercise its option to purchase the property. In the alternative, petitioner contended that if the gains tax is applicable, then consideration should not be based on the entire 21 years of rent payments but only on payments commencing in the 18th year because the option cannot be exercised prior to that time. Petitioner also argued that the original purchase price should be increased based on the provisions of Tax Law § 1440.5(d) which provides that the original purchase price, with respect to the creation of a lease or option, be calculated by a formula taking into account the fair market value of the real property.

Petitioner's counsel received a letter, dated February 21, 1991, from the Division indicating that petitioner's election to pay the gains tax due in installments was accepted as filed.

Petitioner's counsel received a letter, dated March 1, 1991, from the Division denying the refund claim. The Division reasoned that under the gains tax law consideration for such a lease is the present value of the rental payments beginning on the commencement of the lease and continuing until the option is no longer exercisable, plus the consideration paid for the option to purchase the real property; and that Tax Law § 1441 provides that tax on gains derived from real property transfers is imposed on the date of transfer notwithstanding the fact that a lessee subsequently may default on the lease. With respect to the original purchase price, the Division noted that Tax Law § 1440.5(a) applied and that the original purchase price cannot

exceed the amount actually paid for the property. The Division permitted \$700,000.00 to be applied as an original purchase price deduction. This figure was set forth on a closing statement, dated May 10, 1973, with respect to petitioner's acquisition of the premises.

Petitioner requested a conciliation conference. After a conference was held on October 22, 1991, a Conciliation Order, dated February 28, 1992, was issued sustaining the refund denial.

Petitioner filed a petition, dated May 13, 1992, contesting the \$239,905.94 gains tax due. The Division filed an answer, dated August 17, 1992.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner challenges the Division's calculation of the consideration based on the entire 21 years of rental payments. Petitioner contends that the rental payments for the entire lease term should not be taken into account in calculating the consideration paid for the use and occupancy of the real property because:

- "(a) The option may not be exercised by Transferee in any event prior to the 18th anniversary of the Lease Commencement Date, which was January 29, 1991; and
- "(b) Transferee may default under the Ground Lease, if the default remains, uncured, the Petitioner may seek various remedies against Transferee. Such remedies include the termination of the Transferee's rights in the land and the improvements . . . , which would effectively terminate the potential future exercise of the option; and
- "(c) Petitioner may, at any time during the term of the Ground Lease, sell the land to a third party, which sale shall be subject to the Ground Lease, provided that the Transferee does not exercise a right of first refusal."

Petitioner argues that based on these factors, no gains tax is applicable. In the alternative, petitioner contends that if tax is due, consideration should be calculated based on the value of the rental payments commencing in the 18th year, when the option may first be exercised, through the 21st year, when the lease and option to purchase ceases. Accordingly, petitioner calculates the present value of the rental payments for those years to equal \$394,469.22² based

²As noted above, in contrast, the Division calculated the present value of the entire 21-year rental payments to be \$3,649,059.36.

on the following annual rents:

<u>Year</u>	<u>Annual Rent</u>
18	\$560,097.00
19	571,298.00
20	582,724.00
21	594,379.00

Petitioner further argues that the Division incorrectly limited the original purchase price to \$700,000.00, the amount set forth on a closing statement, as petitioner's acquisition cost. Petitioner contends that the Division's reliance on Tax Law § 1440.5(a) is misplaced and that, for purposes of this type of transaction, the original purchase price should be increased in accordance with a formula set forth in Tax Law § 1440.5(d). Tax Law § 1440.5(d) provides that:

"[i]n the case of the creation of a lease or option with use and occupancy, the original purchase price means the amount described in paragraph (a) of this subdivision which relates to the real property or interest therein which is being leased, multiplied by a fraction, the numerator of which is the value of the rental payments under the lease plus the amount paid for an option, if any, and the denominator of which is the fair market value of the real property."

Based on the application of this statutory formula, the Division's calculation of the consideration, and on a fair market value of \$2,250,000.00,³ petitioner increased the original purchase price ("OPP") for gains tax purposes as follows:

$$\text{OPP} = \$700,000.00 \times \frac{\$3,649,059.36 + 0}{\$2,250,000.00} = \$1,135,262.80$$

Petitioner claims that the legislative intent underlying Tax Law § 1440.5(d), which was enacted in 1984, supports its application of the statute.

The Division argues that 20 NYCRR 590.27 specifically provides that a lease for a term less than 49 years which contains an option to purchase the real property is subject to gains tax. It further notes that the transaction being taxed is the creation of a lease with an option to

³With its brief, petitioner submitted an appraisal purportedly evaluating the fair market value of the real property at \$2,250,000.00.

purchase not a transfer of petitioner's complete interest in the property; that the consideration is determined at the time of transfer; and that the Tax Appeals Tribunal has held in other contexts that subsequent events cannot alter the value of the consideration which is calculated at the time of transfer.

With respect to the original purchase price issue, the Division asserts that Tax Law § 1440.5(d) cannot be applied to increase the original purchase price beyond the actual acquisition cost of the real property and that petitioner's appraisal of the fair market value of the property is flawed.

CONCLUSIONS OF LAW

A. Tax Law § 1441 imposes a tax on gains derived from the transfer of real property at the rate of 10% of the gain. Tax Law § 1440.3 defines "gain" as the difference between the consideration for the transfer of real property and the original purchase price. Tax Law § 1440.7 defines "transfer of real property" to include the transfer of any interest in real property:

"by any method, including but not limited to sale, exchange . . . option, . . . [and] the creation of a leasehold or sublease only where (i) the sum of the term of the lease or sublease and any options for renewal exceeds forty-nine years." (Emphasis added; see also, Tax Law § 1440.4.)

In determining the "consideration" paid for the granting of an option with use and occupancy of real property or the creation of a leasehold interest (as defined in Tax Law § 1440.7), the statute provides that consideration shall include:

"the value of the rental and other payments attributable to the use and occupancy of the real property or interest therein and the value of any option to purchase or renew included in such transfer." (Tax Law § 1440.1[b].)

Petitioner raises an interesting issue with respect to consideration under the facts in this case. Petitioner's transaction is subject to gains tax under the statute because there exists an option to purchase. Without that option, the value of the rental payments would not have been subject to gains tax because the lease is for a period less than 49 years. Therefore, according to petitioner's reasoning, because the option to purchase cannot be exercised prior to the 18th year of the lease agreement, the option should be deemed nonexistent and therefore the "transfer" is

not subject to gains tax, or, at the very least, the value of the first 18 years of rental payments should be deemed exempt from "consideration". Petitioner argues, in the alternative, that only the value of the rental payments remaining after the option is exercisable should be included as "consideration".⁴

The regulations address the calculation of the consideration in the situation where leases for less than 49 years contain an option to purchase. The regulations specify that an interest in real property

includes an option and that consideration for such a transfer is the present value of the net rental payments under the lease plus the consideration paid for the option to purchase, but that, "[r]ental payments for periods that occur after an option is no longer exercisable are not included in the calculation of the present value of the rental payments" (20 NYCRR 590.27; emphasis added).

The Division argues that because this regulation does not also contain an exclusion of rental payments that occur before the option is exercisable, the regulation does not support petitioner's theory.

Although interesting, petitioner's argument is unpersuasive. "In assessing whether a transaction is subject to taxation, the statute which levies a tax is construed in favor of the taxpayer" (Matter of Bredero Vast Goed v. Tax Commn. of the State of New York, 146 AD2d 155, 539 NYS2d 823, 825, appeal dismissed 74 NY2d 791, 545 NYS2d 105). However, in the interpretations of what constitutes a "transfer of real property", the courts have recognized that the "statute employs an expansive definition designed to maximize revenues" (id., 539 NYS2d at 825 [and cases cited therein]). The statute unequivocally defines a "transfer of real property" subject to gains tax to include an option to purchase real property.

Notwithstanding that the option to purchase cannot be exercised until year 18 of the

⁴As noted above, the Ground Lease did not provide for a separate payment for the option itself. Therefore, only the present value of the rental payments is at issue.

Ground Lease, the lease nonetheless granted to the transferee an option to purchase the leased property. Thus, for gains tax purposes, the consideration for the option is the present value of the rental payments under the lease plus any consideration paid for the option. There is no statutory or regulatory provision that exempts rental payments made prior to the time an option is exercisable. Petitioner does not point to any exemption that would support its position and, even if it could imply such an exemption in the statutory scheme of Article 31-B, a taxpayer bears the burden of proving entitlement to a statutory exemption by demonstrating that the only reasonable interpretation of the statute provides the exemption claimed (*id.*, 539 NYS2d at 826; Matter of Howes, Tax Appeals Tribunal, March 22, 1990, confirmed 159 AD2d 813, 552 NYS2d 972). Petitioner has not met its burden. The only exemption for rental payments is provided in 20 NYCRR 590.27 for those rental payments that are made after an option is no longer exercisable. Such an exemption is reasonable because at that point the option is nonexistent in contrast to the present situation where the option exists even though it cannot be exercised until year 18.

Petitioner's argument that the option could become nonexistent either due to the transferee's default in rental payments or failure to exercise the option has little merit. As noted by the Division, the Tax Appeals Tribunal and Appellate Division have held that consideration is finally fixed at the time of transfer and events subsequent to that date do not warrant altering the value of that consideration for gains tax purposes (Matter of Cheltoncourt Co. v. Tax Appeals Tribunal, 185 AD2d 49, 592 NYS2d 121).

B. Tax Law § 1440.5(a) defines "original purchase price" as the consideration paid or required to be paid by the transferor "to acquire the interest in real property." Tax Law § 1440.5(d) provides that:

"[i]n the case of the creation of a lease or option with use and occupancy, the original purchase price means the amount described in paragraph (a) of this subdivision which relates to the real property or interest therein which is being leased, multiplied by a fraction, the numerator of which is the value of the rental payments under the lease plus the amount paid for an option, if any, and the denominator of which is the fair market value of the real property."

Using this formula (see, Finding of Fact "16"), petitioner increased the original purchase

price from the \$700,000.00 acquisition cost under Tax Law § 1440.5(a) to \$1,135,262.80. The Division argues that Tax Law § 1440.5(d) may not be applied to increase the original purchase price or acquisition cost of the property. In response, petitioner argues that the legislative intent underlying the enactment of Tax Law § 1440.5(d) in 1984 was to increase the original purchase price. Specifically, petitioner refers to a memorandum of the State Executive Department in support of this section which provides as follows:

"The proposals with respect to the original purchase price of leased property are necessary to provide the lessor or sublessor with an equitable original purchase price so that the entire consideration for each such transfer is not taxable gain. The increase to a lessor's original purchase price in property which was the subject of a taxable lease is necessary so that a subsequent sale of the same property does not tax the same value. The codification of carryover original purchase rules ensures that the value of the real property conveyed in a mere change in form transfer will be taxed in a subsequent taxable transfer" (McKinney's 1984 Session Laws of New York, p. 3460).

The problem with petitioner's reference to the above memorandum is that this memorandum refers to subdivisions (a) through (g) of section 1440.5 and not simply to subdivision (d). The reference in the memorandum to the "increase to a lessor's original purchase price" must be viewed in the context of the entire section 1440.5 which deals with original purchase price. Prior to the 1984 amendments, section 1400.5 did not contain subdivisions (a) through (g). Subdivisions (d) and (e) addressed for the first time in 1984 the original purchase price within the context of the creation of a lease or option to purchase with use and occupancy of the real property.

Subdivision (e) of section 1440.5 permits the lessor to increase the original purchase price upon a subsequent sale to the transferee if the lessor paid gains tax on the transfer of the lease and option. In such a scenario, the original purchase price is increased by the amount calculated as consideration for gains tax purposes (present value of the rental payments plus consideration received for the option) in the prior transfer (see, 20 NYCRR 590.28[b], [c], [d]).

Contrary to petitioner's claim, it is to this subdivision that the legislative memorandum refers when it stated that the proposals were necessary to provide the lessor with "an equitable original purchase price so that the entire consideration for each such transfer is not taxable

gain." Clearly, the memorandum concerns the situation where, after the transfer of the leasehold or option, the lessor transfers the entire interest in the property upon the transferee's exercise of an option to purchase or if the option is not exercised, a transfer to a third party. In either situation, the original purchase price is increased to ensure that the lessor is not taxed twice on the same value.

Moreover, the regulations clarify, with examples, the methods for computing the original purchase price for leases. In 20 NYCRR 590.28(a), the example demonstrates an adjustment to the original purchase price based on the formula contained in section 1440.5(d) where the fair market value (denominator) was more than the sum of the present value of the rental payments and consideration for the option (numerator). Under such a scenario, the original purchase price was decreased proportionally by the fraction. Such a proportional decrease is reasonable inasmuch as the transfer of the leasehold interest and option is not a transfer of the transferor's total interest in the property.

In questions of statutory interpretations, the taxpayer "must show not only that their interpretation is plausible, but also that it is the only reasonable construction available" (Matter of Custom Shop 5th Avenue Corp. v. Tax Appeals Tribunal, ___ AD2d ___ [decided July 8, 1993], citing Matter of Dental Society v. New York Tax Commn., 110 AD2d 988, 989, 487 NYS2d 894 affd on mem below 66 NY2d 939, 498 NYS2d 797). Contrary to petitioner's claim, this subdivision may not be used to increase the lessor's original purchase price. Such a result would be nonsensical and entirely inconsistent with the statutory scheme in calculating the original purchase price for gains tax purposes. Thus, assuming arguendo that petitioner is correct that the fair market value of the property is substantially less than the present value of the rental payments, the statute may not be used to increase the original purchase price beyond petitioner's acquisition cost of the property under section 1440.5(a).

In sum, petitioner's application of section 1440.5(d) has no rational basis and contradicts the entire statutory scheme in calculating the original purchase price under Tax Law § 1440.5 and 20 NYCRR 590.28. Based on the foregoing, there is no need to address the Division's

claim that the appraisal of the fair market value of the real property is flawed.

C. The petition of Von Ford Associates is denied.

DATED: Troy, New York
September 16, 1993

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE